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No. _____

In The

Supreme Court of the United States

October Term, 1984

TEXAS FARM BUREAU,

Petitioners,

vs.

UNITED STATES OF AMERICA,

Respondent.

Petition For Writ of Certiorari
To The United States Court of Appeals
For The Fifth Circuit

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43 pp

QUESTIONS PRESENTED

1. By holding the debt-equity question to be one of law and reversing the District Court's judgment on the verdict, has the Court of Appeals departed from the principles established by this Court in *Commissioner v. Duberstein*, 363 U.S. 278 (1960) and *Pullman Standard v. Swint*, 456 U.S. 273 (1982)?

2. By applying de novo a twelve factor "laundry list" developed for transactions between stockholders and profit corporations to a case involving non-profit affiliated corporations has the Court of Appeals substituted its own fact-findings for those of the District Court and jury to the extent that this Court's supervision is required?

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In The

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October Term, 1984

TEXAS FARM BUREAU,

Petitioners,

vs.

THE UNITED STATES OF AMERICA

Respondent.

Petition For A Writ of Certiorari
To The United States Court of Appeals
For The Fifth Circuit

The Texas Farm Bureau, a non-profit corporation under the laws of the State of Texas, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the Court of Appeals (App. A, *infra*, pp. A-1-A-16) is reported at 725 F.2d 307 (1984). A further opinion issued by the Court of Appeals with the Order denying

Appellee's Petition for Rehearing and Suggestion for Rehearing En Banc (App. D, *infra*, pp. A-21-A-24) is reported at 732 F.2d 437 (1984). The District Court wrote no opinion and is therefore not reported.

JURISDICTION

The judgment of the Court of Appeals (App. C, *infra*, p. A-20) was entered on the 21st day of February, 1984. The Order of the Court of Appeals denying Appellee's Motion for Rehearing and Suggestion for Rehearing En Banc (App. D, *infra*, pp. A-21-A-24) was entered May 21, 1984. No stay of issuance of the mandate was sought or ordered. The jurisdiction of this Court is invoked under 28 U.S.C. §1254 (1).

STATUTORY PROVISIONS INVOLVED

1. 26 U.S.C. §166, Bad debts, provides in relevant part:

(a) General rule.

(1) Wholly worthless debts. There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially worthless debts. When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

STATEMENT OF THE CASE

This case arises from the Internal Revenue Commissioner's disallowance of a bad debt deduction which Petitioner Texas Farm Bureau ("TFB") sought to take in its 1970 fiscal year. Most of the subsidiary facts were undisputed, while the ultimate questions were heavily contested.

I. FACTS OF THE TRANSACTION

The underlying facts, gleaned largely from stipulations, may be summarized as follows: Petitioner TFB is a non-profit corporation under Texas law. Its primary purpose is to provide a variety of goods and services to people engaged or interested in agriculture, generally through a number of non-profit affiliates established and managed by TFB over the years. TFB and its affiliates are exempted from ordinary corporate income tax by 26 U.S.C. §501(c)(5), but must pay tax on unrelated business income under 26 U.S.C. §511. Operating funds for TFB come from individual membership dues and from management fees charged to the affiliates. Transactions between TFB and its affiliate, the Texas Agricultural Marketing Development Association ("TAMDA") are the basis of this suit.

TAMDA was formed to provide cooperative marketing services to its members, mainly in the livestock business and related areas. TAMDA's Board of Directors has always been the same as TFB's. Individual members of TAMDA must belong to TFB. TAMDA has no capital stock and relies on member dues and funds advanced from TFB to meet operating and organizational expenses. Relevant portions of the contract between TFB and TAMDA appear in footnote 2 of the Court of Appeals opinion, 725 F.2d n.2 at 309, Appendix A *infra*, pp. A-3-A-4.

TFB advanced a total of $166,946.02 to TAMDA according to a schedule set out in the Court of Appeals opinion, 725 F.2d at 309, Appendix A, *infra*, p. A-4. Promissory notes bearing 7 percent interest with no fixed maturity date were given for $50,000 of the 1967 advance. The remainder of the advances were carried on TAMDA's

by TFB over the years. TFB and its affiliates are exempted from ordinary corporate income tax by 26 U.S.C. §501(c)(5), but must pay tax on unrelated business income under 26 U.S.C. §511. Operating funds for TFB come from individual membership dues and from management fees charged to the affiliates. Transactions between TFB and its affiliate, the Texas Agricultural Marketing Development Association ("TAMDA") are the basis of this suit.

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TFB advanced a total of $166,946.02 to TAMDA according to a schedule set out in the Court of Appeals opinion, 725 F.2d at 309, Appendix A, *infra*, p. A-4. Promissory notes bearing 7 percent interest with no fixed maturity date were given for $50,000 of the 1967 advance. The remainder of the advances were carried on TAMDA's books as accounts payable and on TFB's books as accounts receivable, with no specified interest rate. A schedule of repayment was not established for the advances. TAMDA made a $3,000 payment to TFB in October 1966 on the advances, but no other during the period in question.

TFB charged TAMDA no management fee until 1968.

In that fiscal year, $73,400 was assessed of which TAMDA paid $25,466.72. TFB wrote the remainder off as uncollectible. These amounts are not in question in this suit.

On its fiscal 1970 tax return, TFB deducted as an uncollectible bad debt $164,118.13, representing unrepaid TAMDA advances for fiscal 1961 through fiscal 1970. There was no litigation between TAMDA and TFB and TAMDA functioned throughout this period.

II. LEGAL PROCEEDINGS

On audit, the Commissioner of Internal Revenue denied the deduction, concluding that the advances did not create debt within the meaning of 26 U.S.C. §166, but were rather in the nature of contributions to capital. TFB paid the assessed deficiency, fruitlessly claimed for refund and then brought suit under 28 U.S.C. §§1346(a)(1) and 26 U.S.C. §7422 in the United States District Court for the Western District of Texas.

REASON FOR GRANTING THE PETITION

1. To resolve a conflict among the Circuit Courts of Appeal concerning the legal nature of and appropriate standard of appellate review for the debt-equity question.

ARGUMENT

In the case at bar, the District Court jury found that the Texas Farm Bureau ("TFB") had properly claimed its bad debt deduction under 26 U.S.C. § 166 for the amounts advanced to its affiliate. The Court of Appeals reversed the judgment based on the fact-findings, holding the debt-equity issue presented to be a question of law, reviewable under the broad de novo standard of appellate review. 725 F.2d 307 (5th Cir. 1984), App. A, *infra*, pp. A-1-A-16. TFB

contends that the Court of Appeals decision is erroneous because the proper analysis for this type of question is that indicated by this Court's decisions in *Commissioner v. Duberstein*, 363 U.S. 273 (1960), and *Pullman Standard v. Swint*, 456 U.S. 273 (1982), *inter alia*, and followed by the majority of the Circuit Courts of Appeals: debt-equity controversies ultimately present a question of fact, susceptible of jury resolution and properly reviewable only under the deferential standard of review accorded the trial court's fact-findings.

Review of this case by this Court would resolve the conflict in approach and analysis of this important question and provide much needed guidance for the federal courts, taxpayers and the government. Currently only the Third, Fifth and Eleventh (following pre-1981 precedent) Circuits consistently treat debt-equity as a legal matter.[1] Ninth Circuit precedent is conflicting,[2] while the remainder of the federal appellate courts as well as the U.S. Claims Court treat debt-equity as a question of fact.[3]

[1] Fifth Circuit other than the case at bar, *see, e.g., Estate of Mixon v. U.S.*, 464 F.2d 394 (5th Cir. 1972); *Slappey Drive Industrial Park v. U.S.*, 561 F.2d 572 (5th Cir. 1977) 3rd Circuit: *Fin Hay Realty Co. v. U.S.* 398 F.2d 694 (3rd Cir. 1968); *Scriptomatic, Inc. v. U.S.*, 555 F.2d 364 (3rd Cir. 1977). The panel opinion's citation of *Diamond Bros. Co. v. Commissioner*, 322 F.2d 725 (3rd Cir. 1963), 725 F.2d n. 9 at 312 (App. A, infra, n. 9 p. A10) appears to be out of date.

[2] Compare *Lundgren v. Comm'r*, 376 F.2d 623 (9th Cir. 1964) with *A. R. Lantz Co. v. U.S.*, 424 F.2d 1330 (9th Cir. 1970).

[3] Federal Circuit: *Electronic Modules Corp. v. U. S.*, 695 F.2d 1367 (1982);
1st Circuit: *Brake and Electric Sales Corp. v. U. S.* 287 F.2d 426 (1961);
2nd Circuit: *Gilbert v. Comm'r.*, 262 F.2d 512 (1958);
4th Circuit: *Road Materials, Inc., v. Comm'r*, 407 F.2d 1121 (1969);
6th Circuit: *Ragland Investment Co. v. Comm'r*, 435 F.2d 118 (1970);
7th Circuit: *Falkoff v. Comm'r*, 604 F.2d 1045 (1979);
8th Circuit: *Matter of Uneco, Inc.*, 532 F.2d 1204 (1976);
10th Circuit: *Williams v. Comm'r*, 627 F.2d 1032 (1980);
see also *Sayles Finishing Plants, Inc. v. U.S.*, 399 F.2d 214 (Ct. C1. 1968).

Authority from this Court's decisions supports the majority rule. In *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946), the decision treated a common variant of debt-equity (interest versus dividends) as a question of fact, properly determined by the Tax Court and not the reviewing Court of Appeals. Further, on at least one occasion, this Court has implicitly assumed that the bad debt deduction poses questions for the trier of fact. *U.S. v. Generes*, 405 U.S. 93, 104 (1972). In the landmark case of *Commissioner v. Duberstein*, cited above, this Court was confronted with a government proposed paradigmatic "factor" test highly analogous to the Fifth Circuit test in this case, as a means to determine whether a transaction was or was not a gift under the Tax Code. Mr. Justice Brennan, writing for the majority at 363 U.S. 288-289, rejected the argument that this gave rise to a question of law:

> The conclusion of whether a transfer amounts to a gift is one that must be reached on consideration of all the factors . . . Decision of the issue presented in these cases must be based ultimately on the application of the fact-finding tribunal's experience with the mainsprings of human conduct to the totality of the facts of each case. The non-technical nature of the statutory language, the close relationship of it to the data of practical human experience and the multiplicity of relevant factual elements with their various combinations, creating the necessity of ascribing the proper force to each, confirm us in our conclusion that primary weight in this area must be given to the conclusions of the trier of fact.

Appellate review is specifically addressed at 290-291:

> One consequence of this is that appellate review of determinations in this field must be narrow. Where a

> jury has tried the matter upon correct instructions, the only inquiry is whether it cannot be said that reasonable men could reach differing conclusions . . . The rule itself applies also to factual inferences from undisputed basic facts . . . as will on many occasions be presented in this area.

That this holding has a much broader application than the meaning of "gift" cannot be doubted. The Sixth Circuit has held that *Duberstein* directly controls appellate review of debt-equity cases. See *Ragland Investment Company v. C.I.R.*, 435 F.2d 118 (6th Cir., 1970) at 119-120, which, like *John Kelley Co.*, cited above, concerned interest versus dividends.

More recently, this Court cited *Duberstein* in its discussion of the primacy of the fact-finder's role in determining issues involving intent. *Pullman-Standard v. Swint*, 456 U.S. 273, 288 (1982). While agreeing that the debt-equity question ultimately involves the intent of the parties, see *Estate of Mixon v. United States*, 464 F.2d 394, 407 (1972), the Fifth Circuit has consistently sidestepped the ultimate factual nature of the intent inquiry via a dichotomization into and "subjective intent," *id.*, the former of which appears to be the sum of the twelve factor *Mixon* paradigm and the latter merely a factor, generally to be disregarded as self-serving. *See* generally *Estate of Mixon, supra, Slappey Drive Industrial Park v. United States*, 561 F.2d 572 (5th Cir. 1977) and others cited in the appellate opinion.

Petitioner TFB's position throughout the course of this lawsuit has been that creation of "debt", like "gift", is controlled by the intent of the parties and that even in a situation, as here, where there are numerous "undisputed basic facts," *Duberstein, supra*, the ultimate inference —

debt or equity, loan or contribution to capital — remains factual, based on "the fact finding tribunal's experience with the mainsprings of human conduct," *id.*, and was properly determined by the jury in the District Court.

Despite this line of authority above and its dominating position in the majority of the Circuits, and despite its own holdings that other debtor-creditor relationships present questions of fact,[4] and despite the fact that this was a case of first impression involving transactions between two non-profit corporate affiliates, the Fifth Circuit treated the debt-equity issue as one of law and reversed the District Court and the verdict. The opinion on motion for rehearing makes clear that advances between non-profit entities such as in this case and advances from a shareholder to an ordinary profit-seeking corporation are to be subjected to the same standard, which however, is apparently *factually distinct*, as a matter of law, from other types of debtor-creditor relationships (Motion denying Rehearing, 732 F.2d 437 at 438. App. D, *infra*, pp. A-21-A-22). This apparent rule that a corporate debt-equity question is a law question and that non-corporate debtor-creditor relationship questions are fact questions is seriously flawed. If consistently followed, the factual or legal nature of the question and thus breadth of appellate review hinge not upon the substance of the transaction, "the totality of the facts of each case," *Duberstein* at 289, but rather upon the *legal status* of the *parties* involved. Despite the Court of Appeals' *Mixon*-factor analysis of the objective factors of the case, ultimately what emerges is a decision based on form rather than substance. Such decisional rules have always been disapproved by this

[4] *See e.g., Saunders v. Commissioner*, 720 F.2d 871 at 873 (5th Cir. 1983).

Court. *See, e.g., Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978).

An additional difficulty with the Court of Appeals decision is the lack of a meaningful rationale for treating the question as a matter of law. While citing four cases to the contrary, the panel opinion merely proclaims that:

> Courts generally bear responsibility for applying debt-equity factors; characterization of an advance as either debt or contribution to capital presents primarily a question of law. (725 F.2d at 311-312, App. A, *infra*, p. A-10).

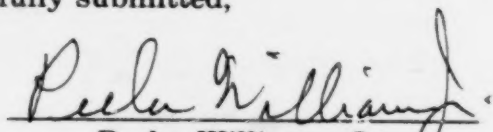
and then proceeds to selectively analyze the *Mixon* factors, downplaying some, emphasizing others and ruling others out as irrelevant. 725 F.2d at 312-314, App. A, *infra*, pp. A-10-A-15.

This is not statutory or constitutional construction or any other traditional question of law analysis. There is no question presented that "bad debt" has any other than an ordinary meaning. This is simply a Court of Appeals redeliberating a set of subsidiary facts and substituting its own findings for those of the District Court jury without benefit of witnesses, live testimony and an opportunity to judge credibility. This was precisely what this Court rejected in *John Kelley Co.*, *Duberstein* and *Swint*. This is precisely the error the majority of Circuits have avoided in treating debt-equity as a question of fact, and giving appropriate deference to the fact-finder's conclusions. TFB respectfully submits that the Fifth Circuit improperly reversed this case.

CONCLUSION

Resolution of this question would provide a greater degree of certainty and uniformity in the law of taxation across this country. It would be an inestimable service to the taxpayers and litigators of this country. For the foregoing reasons, then, Petitioner Texas Farm Bureau respectfully requests that review of this case be granted.

Respectfully submitted,



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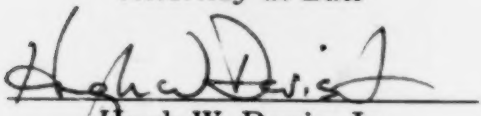

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CERTIFICATE OF SERVICE

I hereby certify that service of this document has been made in accordance with United States Supreme Court Rule 28 by placing four copies of same in an envelope, first class, postage paid, properly addressed to:

Mr. Glen L. Archer, Jr.
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and by placing three copies of same in an envelope, first class, postage paid, properly addressed to:

Honorable Rex E. Lee
Solicitor General
Department of Justice
Washington, D.C. 20530

and depositing the above with the United States Postal Service.

Peeler Williams Jr

Peeler Williams, Jr.
Attorney for Petitioner
AUGUST 29, 1984

APPENDIX A

TEXAS FARM BUREAU,
Plaintiff-Appellee,

v.

UNITED STATES of America,
Defendant-Appellant.

No. 82-1355.

United States Court of Appeals,
Fifth Circuit.

Feb. 21 1984.

Rehearing and Rehearing En Banc
Denied May 21, 1984.

Appeal from the United States District Court for the Western District of Texas.

Before CLARK, Chief Judge, GOLDBERG and POLITZ, Circuit Judges.

GOLDBERG, Circuit Judge:

With Congress' dedicated cultivation, the tax code has prospered and thrived, achieving a rate of growth that tillers of non-legislative soil would be hard-pushed to match. Despite the code's phenomenal size and detail, courts must still contend with a particularly persistent and pesterous ambiguity. The problem lies not in separating the seed from the chaff, but in telling debt from equity.

Debt-equity questions commonly involve a corporation and its shareholders — the issue being whether monies advanced by the shareholder to the corporation constitute a loan or a contribution to capital. Because classifi-

cation of such advances as either debt or equity can produce significant tax consequences, courts frequently have to go beyond the form and into the substance of the particular transaction. As a consequence, courts have developed a set of factors to which they look in resolving debt-equity controversies.

Today we deal with a close cousin of the debt-equity ambiguity. This case poses the same, "loan versus contribution to capital" question present in the shareholder-corporation context. We must decide whether advances by one non-profit corporation to another separate, yet closely linked non-profit corporation constitute loans or contributions to capital. The government disagrees with the contributing corporation's characterization of the transaction as a loan and the corporation's deduction of the unrepaid advances as a bad debt. Fortunately, the precedent derived from debt-equity cases supplies an effective pesticide to eliminate ambiguity in the instant case. Taking guidance from past judicial solutions to debt-equity puzzles, we conclude that the advances in question constituted contributions to capital and not loans.

I. FACTS

Taxpayer, the Texas Farm Bureau ("TFB") is a non-profit corporation, organized and existing under the laws of the State of Texas. TFB's primary purpose is to provide goods and services, including educational benefits, political lobbying services, life and property insurance, and product marketing services, to people engaged or interested in agriculture. These services are generally provided through several TFB affiliates which TFB has established over the years. TFB generates funds for its

operations through individual membership dues and management fees charged to its affiliates. This case involves transactions between TFB and one of its affiliates, Texas Agricultural Marketing Development Association ("TAMDA").

Incorporated in 1961 pursuant to the Cooperative Marketing Act of the State of Texas,[1] TAMDA was created to furnish cooperative marketing services for its members who produce livestock and other agricultural goods. From its inception TAMDA's board of directors has consisted of individuals holding corresponding offices on TFB's board. Membership in TFB constitutes a prerequisite for membership in TAMDA. Formed with no capital stock, TAMDA has relied on membership fees of $5.00 per member and advances from TFB to meet operating and organizational expenses.

The advances from TFB were made pursuant to an April 26, 1961, agreement between TFB and TAMDA ("the agreement").[2] The agreement was signed on behalf

[1] Currently codified at Tex.Agric.Code. Ann. §52.001 et seq. (Vernon 1982).

[2] The agreement (as read into the record) provided, in pertinent part:

> In consideration of the premises [*sic*] promises and of the mutual covenants herein contained, the parties hereto agree to as follows: Farm Bureau agrees and covenants as follows: (a) To provide any and all managerial and clerical services necessary for the conduct of business of the association; (b) To furnish all facilities necessary for the operation of the association; (c) Such facilities shall include but are not limited to office space, office furniture and equipment, files, filing cabinets, telephone service, local and long distance, stationery, postage and supplies; (d) To use its good offices, influence and prestige in promoting the general welfare of the association and to cooperate with the association in carrying on any informational or educational programs designed and intended to promote the association; (e) Not to incur any indebtedness or create any obligations on behalf of

of each party by J. H. West, president of both organizations. It provided that TFB would supply all management and clerical services for TAMDA. In return, TAMDA agreed to reimburse TFB for expenditures made on TAMDA's behalf and to pay TFB "reasonable management fee."[3] The following schedule sets out the yearly totals of TFB's advances to TAMDA:

Fiscal Year Ending October 31	Amount Advanced by Texas Farm Bureau	Cumulative Total
1961	$ 1,398.10	$ 1,398.10
1962	1,482.37	2,88.47
1963	3,133.97	6,014.44
1964	3,399.35	9,413.79
1965	6,461.77	9,413.79
1966	1,690.41	17,875.56
1967	65,128.85	82,694.82
1968	0	82,694.82
1969	80,000.00	162,694.82
1970	4,251.20	166,946.02

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the association, neither implied or otherwise, unless specifically authorized by the association in writing; (f) To be covered at all times in the implementation of this management agreement by the provisions, spirit and intent of the articles of that corporation and bylaws of the association.

Number 2. The association [TAMDA] agrees and covenants as follows: (a) Subject only to the conditions hereof and on presentation of itemized account of expenditures and expenses incurred by Farm Bureau on behalf of and in the interest of the association, the association shall reimburse Farm Bureau for such expenditures and expenses within 30 days of the close of its fiscal year; (b) Pay a reasonable management fee to Farm Bureau as may be mutually agreed to between the association and the Farm Bureau from time to time.

This agreement shall take effect on date of execution and shall continue in full force and effect from such date until the end of the current fiscal year of the association and from year to year thereafter.

Record, Vol. II, pp. 72-73.

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[3] TFB did not charge TAMDA management fees during the period from 1961 through 1967. In 1968, TFB charged a management fee of $73,400. Of this amount TAMDA paid $25,466.72 and TFB wrote off the remaining $48,933.28 as uncollectable. None of that amount is included in the advances in question in this lawsuit.

Promissory notes, bearing a 7 percent interest rate but with no fixed maturity dates, evidenced $50,000 of the 1967 advance.[4] The notes are not part of the record, however, as they have been either lost or destroyed. The parties never established any fixed repayment schedule, and TAMDA never paid any interest on the notes.

Other than the $50,000 advance in the 1967 fiscal year, none of the advances made to TAMDA were evidenced by a note, bond, or other obligation. Furthermore, the parties made no provision for payment of interest on any of this "nonevidenced indebtedness." Except for the partial payment of a management fee assessment[5] and a $3,000 payment made October 26, 1966, TAMDA made no payments towards the management fees or in repayment of advances.

TFB advanced TAMDA an additional $84,351.20 during the 1969 and 1970 fiscal years, despite a 1968 write off of $48,933.28 in management fees owed by TAMDA. Then, in its return for fiscal 1970, TFB deducted as an uncollectible bad debt $164,118.13, representing unrepaid TAMDA advances made from 1961 through 1970. No court action by TFB against TAMDA preceded the write-off. TAMDA never ceased to do business during the 1969-1970 period and was operating at the time of trial.

On audit, the Commissioner of Internal Revenue denied the bad debt deduction. Taking the position that the $164,118.13 in advances constituted contributions to capital that did not become wholly worthless in 1970, he concluded that the advances did not create a bona fide

[4] The $65,128.85 advanced during the 1967 fiscal year included $50,000 furnished to establish a custodial account, as required by the United States Packers and Stockyard Act. 7 U.S.C. §§ 181-229.

[5] *See supra*, n. 3.

debt. Accordingly, the Commissioner assessed deficiencies. TFB paid the amounts assessed and, following denial of its refund claims, sued for a refund in district court.[6]

II. PROCEDURE BELOW AND ISSUES ON APPEAL

The case was tried before a jury. At the close of TFB's case the government moved for a directed verdict. The government argued that because the parties' stipulations resolved any conflict regarding "operative facts," the court should determine as a matter of law whether the advances constituted debt or contributions to capital. The court denied the motion. Subsequently, the jury returned a verdict in favor of the taxpayer, finding that the advances were loans, that TFB held a reasonable expectation of repayment when the advances were made, and that 98% of the debts became worthless in fiscal year 1970. The court denied a government motion for judgment notwithstanding the verdict or, in the alternative, for a new trial.

On appeal, the government argues that the trial court erred in submitting to the jury the issue of whether the advances constituted capital contributions or loans. Rather, as a question of law, the issue should have been decided by the court. In addition, the government contends that given the stipulated facts, the court erred in not holding the advances to be capital contributions.

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[6] The suit seeks a refund for the years 1967, 1968 and 1970. Although I.R.C. § 501(c)(5) exempts TFB from the regular corporate income tax, the organization remains subject to tax on unrelated business income under I.R.C. § 511. TFB's bad debt deductions eliminated its 1970 unrelated business income liability and generated net operating loss carrybacks to 1967 and 1968.

III. ANALYSIS

As we noted above, the issues in this case closely correspond with those arising in common debt-equity cases — cases involving advances from a shareholder to a corporation. Loan transactions between a corporation and its shareholders require special scrutiny primarily because of the lender/shareholder's dual interest in the corporation. *See Tomlinson v. 1161 Corporation*, 377 F.2d 291, 296 (5th Cir. 1967). One manifestation of this dual interest is that, depending on how an advance is structured, the lender's ownership of stock may, in itself, effect a return of capital. Allowing the lender to write off what is essentially an equity interest as a bad debt produces a deduction that corresponds with no real loss.

The advance in the case at bar, however, did not run from shareholder to corporation. Rather, TFB, one non-profit corporation made advances to TAMDA, a separate non-profit corporation. Nevertheless, the circumstances here move us to drawn an analogy to profit corporations and their shareholders.In this case, one of the parties seeks tax advantages through the same technique used by shareholders and profit corporations — proclaiming in words but not in deeds that money put into the corporation constitutes debt rather than capital contributions. TFB holds a substantial interest in TAMDA — one comparable to the interest of shareholders in a profit corporation. Specifically, TAMDA was formed to meet the needs of certain of TFB's members. Record, Vol. 1, p. 229; Trial Transcript, p. 26. The same individuals sit on both boards of directors. TAMDA's members, the analogs of shareholders in a profit corporation, are a subgroup of TFB's members. To the extent that the TFB advances make up

part of TAMDA's financial structure, and to the extent that TAMDA's members benefit financially from TAMDA's success a portion of TFB's membership also benefits. Therefore, TFB's functioning as an organizational proxy for its members, possesses an interest in TAMDA very similar to an equity or shareholder interest.

[1] Given such an interest, the transaction at issue demands the kind of scrutiny regularly given debt-equity controversies. In resolving such controversies courts have looked to the circumstances surrounding the purported loan transaction. Attempts to make this process more rational and consistent have produced a list of specific factors commonly relevant to debt-equity determinations.[7] They are:

(1) the names given to the certificates evidencing the indebtedness;

(2) the presence or absence of a fixed maturity date;

(3) the source of payments;

(4) the right to enforce payment of principal and interest;

(5) participation in management flowing as a result;

(6) the status of the contribution in relation to regular corporate creditors;

(7) the intent of the parties;

[7] The struggle to exterminate debt-equity ambiguities has a long history. *See, e.g., Slappey Drive Industrial Park v. United States*, 561 F.2d 572d (5th Cir. 1977); *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972). *Dillin v. United States*, 433 F.2d 1097 (5th Cir. 1970); *Tyler v. Tomlinson*, 414 F.2d 844 (5th Cir. 1969); *Berkowitz v. United States*, 411 F.2d 818 (5th Cir. 1969(; *Curry v. United States*, 396 F.2d 630 (5th Cir.), *cert. denied*, *393 U.S. 967, 89 S.Ct. 401, 21 L.E.2d 375 (1968)*; *Tomlinson v. 1661 Corp.* 377 F.2d 291 (5th Cir. 1967); *United States v. Snyder Bros. Co.*, 367 F.2d 980 (5th Cir. 1966); *Montclair, Inc. v. Commissioner of Internal Revenue*, 318 F.2d 38 (5th Cir. 1963); *Rowan v. United States*, 219 F.2d 51 (5th Cir. 1955).

(8) "thin; or adequate capitalization;

(9) identity of interest between creditor and stockholder;

(10) source of interest payments;

(11) the ability of the corporation to obtain loans from outside lending institutions;

(12) the extent to which the advance was used to acquire capital assets; and

(13) the failure of the debtor to repay on the due date or to seek a postponement.

Estate of Mixon v. United States, supra, 464 F.2d at 402.

Many of these factors are relevant in this case. Rather than being tailored only to contrast debt with equity in profit corporations, most of the factors focus on the definition of debt under the tax code.[8] They transcent the differences between a shareholder's equity interest and TFB's interest in TAMDA. While we exclude consideration of certain factors in this case because of the particulars of the transaction, such would be the procedure in most debt-equity cases. Even with respect to traditional debt-equity cases, consideration of the factors requires not a simple counting pro-

[8] Judge Brown described the function of the factor analysis in *Tomlinson v. 1661 Corporation, supra.*:

In the course of determining whether a particular transaction creates a valid and subsisting "indebtedness" within the statutory meaning, this court has in the past analyzed the pertinent facts of the transaction in connection with certain criteria considered to be controlling. Generally, these criteria are designed to disclose the real nature of the transaction in question — that is whether it exhibits the characteristics of a bona-fide loan to the corporation which is expected, indeed, may be compelled, to be repaid in full at some future date, or whether as a formalized attempt to achieve the desired tax result while lacking in necessary substances, it merely parades under the false colors of such a transaction.

377 F.2d at 295.

cess, but an evaluation. *Tyler v. Tomlinson, supra*, 414 F.2d at 848, *Slappey Drive Ind. Park v. United States, supra*, 561 F.2d at 581. Depending on the particular facts of a case, different factors come to the fore. *Slappey*, 561 F.2d at 581; *Curry v. United States, supra*, 396 F.2d at 633-34.

A. *Debt or Capital Contributions — A Question of Law*

Courts generally bear responsibility for applying debt-equity factors; characterization of an advance as either debt or contribution to capital presents primarily a question of law.[9] *Estate of Mixon v. United States, supra*, 464 F.2d at 402; see also *Slappey Drive Industrial Park, supra*, 561 F.2d at 582, n. 17; *Tyler v. Tomlinson*, 414 F.2d at 850. We perceive no reason to deviate from this general rule under the facts of the instant case.

[2] The only exception to debt-capital contribution determination as a matter of law arises when a court must rely on the parties' subjective intent, factor number seven. Issues of intent pose questions of "pure fact." *Bryam v. United States*, 705 F.2d 1418 (5th Cir. 1983); see also *Pullman-Standard v. Swint*, 456 U.S. 273, 102 S.Ct. 1781, 72 L.Ed.2d 66 (1982). But, reliance on subjective intent and the submission of the debt-capital contribution question to a jury becomes necessary only when a court's analysis of other, objective factors fails to provide clear signals. The *Mixon* court stated that where "the objective facts of the case are ambiguous and do not result in a clear manifestation of

[9] Contra, *see Electronic Modules Corp. v. United States*, 695 F.2d 1367, 1371 (Fed.Cir. 1982); *Sayles Finishing Plants, Inc. v. United States*, 399 F.2d 214, 218, 185 Ct. Cl. 196 (1968); *Diamond Bros. Co. v. Commissioner*, 322 F.2d 725, 730 (3rd Cir. 1963); *Gilbert v. Commissioner*, 262 F.2d 512, 513 (2d Cir.), *cert. denied*, 359 U.S. 1002, 79 S.Ct. 1139, 3 L.Ed.2d 1030 (1959).

objective intent, then subjective intent is relevant on the issue." *Mixon, supra*, 464 F.2d at 407. The court, though, in *Tyler v. Tomlinson, supra*, 414 F.2d 844, pointed out that reliance on subjective intent should indeed be the exception.

> Tax law requires that creditorship have genuine existentiality (citation omitted). This requires more than a declaration of intention to create an indebtedness and more than the existence of corporate paper encrusted with the appropriate nomenclature captions.
>
> If appellants mean to say that a mere showing of an intent to create an indebtedness and the existence of something called "notes" is sufficient to take their case to the jury, we must disagree. If that were true, every debt-equity case would require a jury verdict no matter how transparent the attempt at tax avoidance. We, therefore, look not to mere labels or to the self-serving declarations of the parties, but to the more reliable criteria of the circumstances surrounding the transaction.

414 F.2d at 850.

TFB argues that the instant case falls within the exception where consideration of subjective intent is necessary. Maintaining that the facts stipulated to in the trial court left substantial ambiguity as to the import of the relevant, objective, debt-equity factors, TFB argues that the issue of intent was properly submitted to the jury. Determination of this first issue, therefore, requires an analysis of the relevant, objective factors surrounding TFB's advances to TAMDA.

B. *Debt or Capital Contributions the Objective Factors*

Turning to that analysis, we note that three factors point weakly towards debt. Factor one, the names given

to the certificates evidencing the indebtedness, suggests debt with respect to $50,000 of the advances. "Notes" evidenced that amount of the $166,946.02 total.[10] This indicator has little force, however. After the original notes were either lost or destroyed,[11] the parties never issued new notes to replace them. In addition, of the twelve "objective" *Mixon* factors, factor one has the largest subjective content. The parties' decision to call the certificates "notes" sheds little light on the transaction's real substance. In any case, to the limited extent that factor one indicates debt, we find other factors overriding.

Factor nine, identity of interest between creditor and shareholder, also weighs lightly in the instant analysis. It applies specifically to the situation where shareholders have advanced funds to their corporation. The focus is on whether a contributing shareholder owns the same portion of the company's stock as he does of the purported debt. If "proportionality" exists, how the contributor breaks down the advance between debt and equity will not affect control of the company. *See Slappey Drive Ind. Park v. United States, supra,* 561 F.2d at 583. In such circumstances tax considerations may well be the primary force in the contributor's characterization of the transaction. Strictly speaking, the factor does not apply to the case at bar, one involving an advance between two non-profit corporations. The underlying notion of identity of interest does have relevance, however. A complete identity of interests would exist between TFB as creditor and TFB as representative of TAMDA's members if the

[10] TFB advanced $114,198.13 without a note or other indicia of indebtedness.

[11] *See supra*, p. 309.

two organizations had identical memberships. Because TAMDA's members comprise only a subgroup of TFB's members, symmetry of interests is incomplete. The factor thus cuts somewhat in favor of a finding of debt. But, even its limited significance fades in the light of the other factors.

Next we observe that the agreement between TFB and TAMDA established a fixed due date for repayment of the advances. Again, however, the circumstances of this case negate this factor's importance. Although the agreement between TAMDA and TFB required repayment of the advances within 30 days of the close of each year, that provision was a dead letter. TFB advanced money to TAMDA year after year, despite TAMDA's failure to comply with the repayment provision. Moreover, the very limited outside financial resources of TFB,[12] coupled with the complete identity between the two organizations' board of directors, makes illusory the notes' payment on demand provisions. *See Tyler v. Tomlinson, supra,* 414 F.2d at 849.

Turning to the remaining, relevant factors,[13] we find that they unwaveringly indicate that the advances were not debt. TAMDA's dependence on its earnings to repay TFB's advances is one illustration. The only documented nonearnings source for repayment of TFB lay in dues

[12] *See* infra, p. 313.

[13] Two of the *Mixon* factors have no bearing on the instant case. Factor five, whether the source of the advances took an increased management role in the recipient, cuts neither way because of the complete identity among management personnel in TAMDA and TFB. No increase in management role was possible for TFB. Ability to obtain loans from outside lending institutions, factor eleven, provides no help either. Unless TFB or its individual members guaranteed the debt, TAMDA never attempted to secure credit from outside sources.

paid by TAMDA's members. But, given a yearly dues income of only $3,000,[14] TAMDA would have to look elsewhere to repay TFB — i.e., to the commissions it charged for marketing services. Record Vol. I, p. 104. The dependence on membership dues also raises the factor of inadequate capitalization. With such limited resources, TAMDA could hardly have been more tinly capitalized.

TFB's "right to enforce payment of principal and interest" was only a mirage. The agreement signed at TAMDA's inception gave TFB a contractual right to repayment. In actuality, however, repayment fell within TAMDA/TFB management discretion. The complete overlap in the boards of TFB and its affiliate precluded any arms-length relationship — any realistic expectation that a demand for payment would be made or legal enforcement actions would be taken. TFB stipulated in the trial court that it never took "formal collection actions" against TAMDA despite TAMDA's repeated failures to meet the annual due dates. Record, Vol. I, p. 104. In addition, the advances were *de facto* subordinated to TAMDA's corporate debt. TAMDA failed to meet its obligations to TFB while still meeting all of its obligations to other creditors.

TAMDA's *use* of the advances also leads us to conclude that they were not debt. TAMDA spent the advances on basic operating costs such as rent, supplies, travel, etc. While the advances were not used to obtain capital assets, the organization wholly depended on the advances to begin functioning. Purchase of such "necessary first assets" points us away from a finding of debt. *Slap-*

[14] TAMDA had 600 members during the relevant period, each member paying $5 in annual dues.

pey Drive Industrial Park, supra, 561 F.2d at 583.

A particularly important indicator in distinguishing debt from capital contributions focuses on interest payments. As this court stated in *Curry v. United States, supra*, 396 F.2d 634, " a true lender is concerned with interest." In this case, the agreement under which TFB advanced $114,118.13 did not call for payment of interest. Even with respect to the interest-bearing $50,000 notes, TAMDA never made a single interest payment. Failure to insist on interest payments clearly demonstrates that TFB was not concerned with interest income. Rather like an equity holder, TFB cared more about the continued operation and growth of TAMDA. *See id.; Estate of Mixon v. United States, supra*, 464 F.2d at 409.

IV. CONCLUSION

[3] *Slappey Drive, supra*, articulated the essential difference separating lenders and holders of an equity interest: "shareholders place their money 'at the risk of the business' while lenders seek a more reliable return." 561 F.2d at 581, *see also Midland Distributors, Inc. v. United States*, 481 F.2d 730, 733 (5th Cir. 1973); *Dillin v. United States, supra*, 433 F.2d at 1103. Self-serving assertions that payment was expected cannot be substituted for some concrete demonstration of the actual existence of such expectations. We have analyzed the laundry list of objective factors relevant to whether the relationship at issue was one of a debtor or creditor. We can find no maimed creditor. The absence of fixed, realistic dates for repayment, the failure to provide for meaningful enforcement mechanisms, the dependence of TAMDA upon its earnings to repay the advances, the *de facto* subordination of the TFB debt to other debt, t he use of the

advances for initial operating expenses, and the lack of emphasis on interest cut strongly against the notion that the advances were debt. Analysis of these factors shows us the true and unambiguous nature of TFB's advances to its affiliate. TFB hoped to profit by its relationship with TAMDA and furnished the capital to keep it going. No other scenario can be reeled out. The district court erred in not finding that the advances were, as a matter of law, contributions to capital.

The problem of distinguishing debt from capital contributions has been with us and will likely remain with us for a long time. Primary reliance upon subjective indications of intent is simply not an effective way of resolving that problem. In a land of hard economic facts, we cannot root important decisions in parties' pious declarations of intent. Awarding the government its rightful harvest, we hold that TFB's advances to TAMDA were not loans and therefore were not deductible as bad debts. The ruling of the district court is,

REVERSED.

APPENDIX B

In the United States District Court
for the Western District of Texas
Waco Division

Texas Farm Bureau, Plaintiff

v.

United States of America, Defendant

Civil No. W-79-CA-120

FINAL JUDGMENT

The above-styled cause was tried before the Court and a jury on March 15 and 16, 1982, and the jury returned its verdicts as follows:

1. Do you find that the advances which Texas Farm Bureau made to, or paid on behalf of, TAMDA were in the nature of a loan or an investment?

Answer "Loan" or "Investment."

Answer: *"Loan"*.

If your answer to Question 1 was "Investment," do *not* answer the remaining questions. If your answer to Question 1 was "Loan," then answer Question 2.

2. Do you find that, at the time Texas Farm Bureau made the advances, there was a reasonable expectation that TAMDA would repay the advances?

Answer "Yes" or "No."

Answer: *"Yes"*.

If your answer to Question 2 was "No," do *not* answer the remaining questions. If your answer to Question 2 was "Yes," then answer Question 3.

3. Do you find that the advances were bona fide debts which became worthless, in whole or in part,

in the fiscal year of Texas Farm Bureau which ended October 31, 1970?

Answer "Yes" or "No."

Answer: *"Yes"*.

If your answer to Question 3 was "No," do *not* answer Question 4. If your answer to Question 3 was "Yes," then answer Question 4.

4. What percentage of the advances do you find were bona fide debts which *became* worthless in the fiscal year ending October 31, 1970?

Your answer should be a percentage from 0 to 100 percent.

Answer: *98%*.

On the basis of the foregoing jury verdicts, it is hereby ORDERED, ADJUDGED and DECREED as follows:

1. That Texas Farm Bureau recover from the United States of America the sum of $14,801.82 as an overpayment of federal income taxes and assessed interest for its fiscal year ended October 31, 1967, consisting of $11,673.74 tax and $3,128.04 assessed interest;

2. That Texas Farm Bureau recover from the United States of America the additional sum of $5,418.77 as an overpayment of federal income taxes and assessed interest for its fiscal year ended October 31, 1968, consisting of $3,904.13 tax and $1,514.64 assessed interest;

3. That Texas Farm Bureau recover from the United States of America the additional sum of $74,916.01 as an overpayment of federal income taxes and assessed interest for its fiscal year ended October 31, 1970, consisting of $59,083.95 tax and $15,832.07 assessed interest;

4. That, in addition to the cumulative amount of $95,136.60 awarded in paragraphs 1, 2 and 3 above,

Texas Farm Bureau recover interest from the United States of America on the above cumulative amount from the date of payment by Texas Farm Bureau, with such interest to run at the annual rates established under Section 6621 of the Internal Revenue Code of 1954 (26 U.S.C.); and

5. That each party bear its own costs.

ENTERED THIS 8th day of April, 1982.

Lucius D. Bunton

Approved As to Form:

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APPENDIX C

In the
United States Court of Appeals
For the Fifth Circuit

No. 82-1355

D. C. Docket No. W-79-CA-120

Texas Farm Bureau, Plaintiff-Appellee,

versus

United States of America, Defendant-Appellant.

Appeal from the United States District Court for the Western District of Texas.

Before CLARK, Chief Judge, GOLDBERG and POLITZ, Circuit Judges.

JUDGMENT

This cause came on to be heard on the record on appeal and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment in this cause be, and the same is hereby, reversed;

IT IS FURTHER ORDERED that the plaintiff-appellee pay to the defendant-appellant the costs on appeal, to be taxed by the Clerk of this Court.

February 21, 1984

ISSUED AS MANDATE: June 4, 1984

APPENDIX D

In the United States Court of Appeals
For the Fifth Circuit
No. 82-1355.

Texas Farm Bureau,
Plaintiff-Appellee

v.

United States of America,
Defendant-Appellant.

Appeal from the United States District Court
For the Western District of Texas

ON PETITION FOR REHEARING AND
SUGGESTION FOR REHEARING
EN BANC

(Opinion February 21, 1984, 5 Cir.,
1984, 725 F.2d 307)

Before CLARK, Chief Judge, GOLDBERG and POLITZ, Circuit Judges.

PER CURIAM:

Appellee seeks rehearing on the basis that the Court's holding in this case, that the "debt versus contribution to capital" issue presents primarily a question of law, conflicts with existing Fifth Circuit authority. While we do not agree with this contention, we pause briefly to fit the holding in this case more securely into the Circuit's jurisprudence.

Between the time this case was argued and the time that the panel decided it, *Saunders v. Commissioner of Internal Revenue*, 720 F.2d 871 (5th Cir. 1983) was decided. *Saunders* involved funds distributed by an edu-

cational trust established by an employer-corporation for the benefit of its employees' children. In that case, the Court affirmed a Tax Court finding that the funds distributed by te trust were taxable income to the corporation's employee. Applying the "clearly erroneous" standard of review, the Court stated that, "[w]hether a certain transaction creates a creditor-debtor relationship is a question of fact for the trier of fact," and that, "[i]ntent is the determinative factor." Appellee argues that *Saunders* is inconsistent with the panel's holding in this case. Our view of the two cases, however, suggests otherwise.

[1,2] Although both cases pose the general question of whether a debtor-creditor relationship has been created, they arise from two different and discrete factual contexts. In the debt versus equity area, involving transactions between a corporation and an entity with an interest in that corporation, this Court has developed a set of objective factors to aid courts in making the determination whether the particular transaction creates debt. *Slappey Drive Ind. Park v. U.S.*, 561 F.2d 572, 582 (5th Cir. 1977); *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972); *Montclair, Inc. v. Commissioner of Internal Revenue*, 318 F.2d 38 (5th Cir. 1963). Furthermore, decisions of this Court establish beyond peradventure that in the Fifth Circuit debt-equity determination is ordinarily a question of law to be decided by the court. *Slappey Drive Ind. Park, supra*, 561 F.2d at 582, n. 17; *Estate of Mixon, supra*, 464 F.2d at 402; *Tyler v. Tomlinson*, 414 F.2d 844, 850 (5th Cir. 1969). Although in some situations intent may play an important role in debt-equity determinations, *Estate of Mixon, supra*, 464 F.2d

at 407, courts look to intent only when other relevant, objective factors regarding the transaction fail to clearly indicate either debt or equity. *Id.*; *Tyler v. Tomlinson, supra*, 414 F.2d 844.

[3] In deciding this case, we carefully analyzed the facts surrounding the relevant transaction and concluded that, despite certain differences, the transaction closely resembled a transaction between a corporation and its shareholder. We concluded that, consistent with the general rule in the area of debt-equity, intent should not be determinative. An analysis of the transaction's relevant, objective factors unambiguously indicated that Texas Farm Bureau had made a contribution to capital to its offspring corporation and not a loan. In *Saunders* on the other hand, the Court made no such analogy between the transaction at issue and the debt-equity situation. *Tyler v. Tomlinson, supra*, and its progeny were nowhere mentioned; rather, intent was declared to be determinative. Thus Fifth Circuit law, with respect to distinguishing debt from compensation, is different from the law with respect to distinguishing debt from contributions to capital. However, the court's choice in *Saunders* not to place primary reliance upon a "legal evaluation" of objective factors, does not affect the long line of precedent in the debt-equity area.

For the same reasons that *Saunders* is distinguishable, we find that this case is not controlled by *Byram v. United States*, 705 F.2d 1418 (5th Cir. 1983). In that case, the Court held that "the purpose for holding property . . . is a question of intent and motive" and "as such, it is a question of pure fact." *Id.* at 1423. The facts in *Bryam* called for distinghishing "capital assets" from assets held

"primarily for sale to customers in the ordinary course of [the taxpayer's] trade or business."[1] This is a wholly different task from the one in the case at bar. The very words, "purpose for holding property" suggests that intent and motive should be pivotal in making the necessary determination. Conversely, there is nothing about the task of distinguishing debt from equity that necessarily calls for consideration of subjective belief. A party could earnestly believe that a certain advance to a corporation fits the party's individualized notion of "debt," but that notion might range far from a definition of debt derived from business community norms or from the law.

Finally, in *distinguishing* this case from *Saunders* and *Byram*, we pause to reaffirm our conviction that the holdings of *Tyler v. Tomlinson, supra, Estate of Mixon, supra* and *Slappey Drive Ind. Park, supra*, remain solidly entrenched as law in this Circuit. Our high technology age has yet to produce an accurate, dependable means for determining a man's subjective beliefs. At least until such a development occurs, reliance on more objective types of evidence is generally desirable. This Court has chosen this latter path with respect to resolving debt versus equity controversies. We need not under the facts of this case, deviate from letter or logic of that precedent.

The Petition for Rehearing is DENIED, and no member of this panel nor judge in regular active service on the court having requested that the court be polled en banc (Federal Rules of Appellate Procedure and Local Rule 35), the Suggestion for Rehearing En Banc is DENIED.

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[1] 25 U.S.C. §1221.